Office of Chief Counsel
Internal Revenue Service

memorandum

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HPLevine, ID# 62-09574

date: March 6, 2000

to: Chief, Examination Division, Kentucky-Tennessee District
Attention: Revenue Agent Don Kotval

from: District Counsel, Kentucky-Tennessee District, Nashville

subject: [redacted]
The extent that an I.R.C. § 481 adjustment can be made to a partnership which received a transferred asset

DISCLOSURE STATEMENT

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ISSUES:

1. Whether an I.R.C. § 481 adjustment can be made against a partnership in which the taxpayer transferred assets where the taxpayer failed to properly capitalize interest under the UNICAP rules?

2. What alternatives are available for properly reflecting the income of the taxpayer where it failed to properly capitalize interest in accordance with the UNICAP rules?

CONCLUSIONS:

1. An I.R.C. § 481 adjustment ***cannot*** be made against a partnership in which the taxpayer transferred assets where the taxpayer failed to properly capitalize interest under the UNICAP rules.

2. Presuming that Rev. Proc. 94-68 can be satisfied, the Internal Revenue Service can reopen the examination of the taxpayer and propose the I.R.C. § 481 adjustment against it since there is sufficient time on the statute of limitations to do so.

FACTS AND DISCUSSION:

[redacted] (hereinafter Old [redacted] is under examination for the [redacted] and [redacted] periods. Old [redacted] entered into multiple transactions in [redacted] in order to dispose of [redacted], [redacted] and [redacted], to [redacted], parent of [redacted]. Both Old [redacted], now known as [redacted] and New [redacted] are still in existence although the old common parent, Old [redacted], is no longer the parent of or a member of the consolidated group. Through the multiple mergers and transactions, the parties transferred the desired assets into Old [redacted] (the parent), and the undesired assets into New [redacted] (the subsidiary), spun off New [redacted] as a separate group and engaged in a tax-free exchange with [redacted] for Old [redacted]. The tax returns for the former parent, Old [redacted], are under examination. The tax return for the [redacted] period was in the name of [redacted] and signed by their officer. The tax return for the [redacted] period was prior to the transactions and was in the name of Old [redacted] and signed by a [redacted] officer. [redacted] and New [redacted] have disaffiliation agreements detailing the liability between the parties and the extent that assistance in any income tax examination will be provided.

You have identified a potential issue involving the capitalization of construction interest. The taxpayer has been involved in several substantial construction projects, where it has enlarged the [redacted]. They deducted construction interest which should have been capitalized. The [redacted] asset was owned by the taxpayer until [redacted]. The asset and liability were transferred to a partnership on [redacted]. This was done to avoid the State excise and franchise tax. The partnership filed a short year for the calendar year ending [redacted]. The two partners are subsidiaries of Old [redacted] (now [redacted]. The Internal Revenue Service did not make an interest capitalization adjustment in [redacted] or [redacted].

The issue is whether the Internal Revenue Service can recover from the partnership as a prior period adjustment, the deductions erroneously deducted by the corporate taxpayer before the asset transfer. You indicate that the statute of limitations is still open under extension until [redacted] for the [redacted] and [redacted] taxable years of Old [redacted] and that the Internal Revenue Service could try to make the adjustment in [redacted], the last full year in which the taxpayer owned the asset.[1]

Where there has been a change in a method of accounting, an adjustment can be made under I.R.C. § 481 to the extent necessary to prevent amounts from being duplicated or omitted by reason of the change. You have concluded that an incorrect method of accounting was used to account for construction interest and that the method of accounting should be changed which will necessitate an I.R.C. § 481 adjustment.[2] We conclude that the method of accounting must be changed and the I.R.C. § 481 adjustment made against the same taxpayer that received the benefit of having utilized the incorrect method of accounting. In this case, that would be Old [redacted] and not the partnership, although a change in method of accounting can also be made against it. In that event, the I.R.C. § 481 adjustment would be limited to the amount of construction interest that the partnership improperly deducted and would have to be made in the second year as discussed below.

Under I.R.C. § 481, the Internal Revenue Service can make an adjustment where a taxpayer's taxable income for a taxable year is different from the method used by the taxpayer in computing income for the preceding year. By its terms, I.R.C. § 481 requires that the taxable income of the ***same taxpayer*** be compared for two separate taxable years. The threshold question therefore is whether entities involved in tax-free transactions (such as in one involving I.R.C. § 351) are considered to involve the same entity for I.R.C. § 481 purposes. The analysis is relevant to this case since a tax-free exchange under I.R.C. § 721.

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[1] For purposes of this legal analysis, we presume that the statute of limitations is open under extension. We would need to review the facts and the statute extension in order to make an independent statute of limitations legal determination should you wish for us to do so.

[2] We reach no conclusion on the correctness of your legal determination. Rather, we presume that your legal determination is correct. We can separately address the appropriateness of changing the method of accounting and of the I.R.C. § 481 adjustment at your request.

Entities operated as corporations and partnerships are separate and distinct. Hempt Bros., Inc. v. United States, 490 F.2d 1172 (3rd Cir. 1974). Because they are separate entities, the courts have held that an I.R.C. § 481 adjustment cannot be made in the first taxable year of the successor entity since it had no preceding taxable year. Id; Ezo Products Co. v. Commissioner, 37 T.C. 385 (1961); Pittsfield Coal & Oil Company v. Commissioner, T.C. Memo. 1966-4. It is also firmly established that because separate entities are involved, I.R.C. § 481 may not be applied to make adjustments involving the method of accounting used by the predecessor entity. Id.; Dearborn Gage Company v. Commissioner, 48 T.C. 190 (1967); Shore v. Commissioner, 631 F.2d 624 (9th Cir. 1980); and Grogan v. United States, 364 F.Supp. 564 (N.D. Ga. 1972) (proprietorship to partnership).[3] Consequently, we do not believe that because of a method of accounting change against the partnership, the Internal Revenue Service can recover erroneously treated items made by the predecessor entity which owned the asset and which used an improper method of accounting. Rather, the adjustment must be made directly against the entity which used an erroneous method of accounting which caused it to overstate deductions.[4]

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[3] Although the cases in which this issue has arisen involved tax-free reorganizations under I.R.C. § 351, there is no conceptual difference with a partnership contribution under I.R.C. § 721 since both operate as tax-free transactions. In the case of a partnership contribution of only partial assets, the continuity argument is more attenuated since both entities remain in existence. The interrelationship between I.R.C. § 351 and § 481 has been previously addressed. The argument that the lack of continuity for I.R.C. § 481 purposes undercuts I.R.C. § 351 has been rejected. Shore v. Commissioner, 631 F.2d 624 (9th Cir. 1980). It is the continuity of the taxpayer that is determinative. Id. In this case, since both taxpayers remained in existence with one with ownership of the other, it is clear that the two entities are not the same taxpayer for I.R.C. § 481 purposes.

[4] A change in the method of accounting and an I.R.C. § 481 adjustment can be made against the partnership in year two [redacted]). However, the I.R.C. § 481 adjustment would be limited to the amount of interest erroneously deducted by the partnership in the current and prior partnership year.

Rev. Proc. 94-68 provides the conditions under which a closed case can be reopened.[5] Section 5 provides that the Internal Revenue Service will not reopen a closed case after examination to make an adjustment unfavorable to the taxpayer unless inter alia: (1) the prior closing involved a clearly defined substantial error based on an established existing Internal Revenue Service position; or (2) other circumstances indicate that the failure to reopen the case would be a serious administrative omission. See also IRM 4023.4.

A clearly defined error is one which is clearly apparent as opposed to being vague or uncertain. IRM 4023.5(2)(a). An error is deemed substantial if it is over $10,000.00. IRM 4023.5(b)1.a. A serious administrative omission includes three defined circumstances, to wit: (1) one which would result in serious criticism of the Internal Revenue Service's administration of the tax laws; (2) one which would establish a precedent that would seriously hamper subsequent attempts by the Internal Revenue Service to take corrective action; and (3) one which would result in inconsistent treatment of similarly situated taxpayers. IRM 4023.5(1).

For purposes of this case, it appears that the basis in which you would proceed to attempt to reopen the case would be based on a clearly defined substantial error. Since this is a policy matter and not a legal issue, we express no opinion on whether the criteria have been satisfied. IRM 4023.6 provides the procedures for a reopening initiated by the Internal Revenue Service.[6]

As an aside, for taxable years ending after August 5, 1997, the TEFRA provisions were changed, and the small partnership exception applied after that time to partnerships with less than ten partners even if the partners were C corporations. I.R.C. § 6231(a)(1)(B). You may want to determine whether the revised TEFRA rules apply for the [redacted] taxable year. We can assist you in this determination at your request.

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[5] A closed case includes the situation where the taxpayer has been notified in writing of adjustments to its tax liability. We understand that adjustments were proposed and agreed to by the taxpayer for the [redacted] and [redacted] taxable years.

[6] To the extent that the case is reopened and a second inspection of the books and records is made, then you must also comply with I.R.C. § 7605(b). See Rev. Proc. 94-68.

I.R.C. § 6231(a)(1)(B)(ii) provides that a taxpayer can elect to have the consolidated TEFRA audit rules apply. The election is valid for the taxable year in which it was made and all subsequent years unless revoked with consent of the Secretary. I.R.C. § 7805(d) provides that any election required to be made under the Internal Revenue Code shall be made at the time and manner as prescribed by the Secretary.

Temporary Treas. Reg. § 301.6231(a)(1)-1T provides guidance on the small partnership exception.[7] Under Temporary Treas. Reg. § 301.6231(a)(1)-1T, the election was generally required to be made by filing a statement at the time that the partnership return for the first taxable year in which the election was to be effective.[8] However, the regulation also allows for an election to be filed prior to the date one year before the statute of limitations expires if it pertains to a taxable year for which a partnership return is to be filed before 90 days after the date final regulations are published in the Federal Register. A taxpayer can make an election in a manner other than on a tax return until final regulations are published.

You may want to determine if the TEFRA provisions apply, and if not, whether the taxpayer wants to make an election to have it apply. In order to make the election, the taxpayer must identify the election and it must be signed by all persons who were partners for the taxable year in which the election is to be made. An authorized corporate officer must sign for a corporate partner. Under I.R.C. § 6062, a corporation's income tax return

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[7] Temporary Treas. Reg. § 301.6231(a)(1)-1T was published in the Federal Register on March 5, 1987 and March 24, 1987. While a temporary regulation usually expires automatically pursuant to a sunset provision contained in I.R.C. §7805(e)(2), the sunset provision is effective only for regulations issued after November 20, 1988. Therefore, Temporary Treas. Reg. § 301.6231(a)(1)-1T is still applicable.

[8] Rev. Proc. 83-8, 1983-1 CB 639 was issued to provide guidance on elections to have the TEFRA procedures apply where they would otherwise not apply since the taxable year began prior to September 3, 1982. Since this election concerns a different issue under the TEFRA procedures and since Temporary Treas. Reg. § 301.6231(a)(1)-1T squarely addresses the issue present in this case and is still applicable, we do not believe that Rev. Proc. 83-8 has any relevance to the election made in this case. The biggest differences were that Rev. Proc. 83-8 required the election to be made under penalties of perjury and further required the election to be made by the tax matters partner and not the partners as required under the treasury regulation.

must be signed by the president, vice-president, treasurer, assistant treasurer, chief accounting officer or any other person authorized at act. The Internal Revenue Service takes the position that a person who is authorized to sign a corporate income tax return can also sign a statute extension.

Because of the technical nature of the I.R.C. § 481 issue, we are seeking post-review by the National Office of the advice contained herein. We expect to hear shortly from them and we suggest that you wait to further hear from this office before you make a final determination on these issues although we suggest that you give them preliminary consideration considering the imminent expiration of the [redacted] and [redacted] statute of limitations should you choose to reopen those examinations.

Attached is a client survey which we request that you consider completing. The client survey is an attempt to measure your satisfaction with the service provided by this office. We expect to be able to use your response to improve the services that we provide to you. Please contact the undersigned at (615) 250-5072 if you have any questions.

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